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No. 125

In the

Supreme Court of the United States

OCTOBER TERM, A.D. 1970

UNITED STATES OF AMERICA,

Petitioner,

vs.

WILLIAM L. RANDALL,

Trustee.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit.

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

QUESTION PRESENTED

"Whether, under Section 7501(a) of the Internal Revenue Code of 1954, Social Security and income taxes withheld from salaries paid to employees by a debtor in possession during an arrangement under Chapter XI of the Bankruptcy Act constitutes a trust fund that is not a part of the arrangement estate to be distributed to creditors in a subsequent liquidating bankruptcy proceedings" is not precisely the question presented by the record (Gov't's Br. 2).

The question presented is whether when the debtor in possession fails to deposit Social Security and income tax funds withheld and the Government is unable to trace these funds, it should, nonetheless, be entitled to have a trust impressed on the proceeds realized from the sale of the debtor's physical assets and be favored thereby even to the virtual exhaustion of the assets of the estate, contrary to the priorities of Section 64a of the Bankruptcy Act?

STATEMENT

It is not altogether accurately asserted by the Government, in the "statement" portion of its brief, that the referee denied its petition in the bankruptcy proceedings to enforce a trust in its favor under Section 7501(a) of the Internal Revenue Code of 1954 through payment of the amount of withheld taxes prior to the payment of the costs and expenses of administration (Gov't's Br. 3-4).

The facts are that the referee allowed the Government's petition as to withheld taxes deposited by the debtor (of which there proved to be none) but denied further imposition of a trust on all other assets of the estate (A. 44).

SUMMARY OF ARGUMENT

Inasmuch as Section 7501(a) of the Internal Revenue Code of 1954 and Section 64a(1) of the Bankruptcy Act both deal with tax obligations, they should be construed, if possible, to give effect to both.

Construing the trust created by the first sentence of the former to be expressly limited to non-bankruptcy matters by the second sentence thereof permits effect to be given to both enactments.

The Government thereby retains favorable collection procedures against persons collecting or withholding taxes from others and, yet, the bankruptcy priorities are preserved when that Court intervenes.

On the other hand, should these statutes be held irreconcilable then the preference accorded the Government under Section 7501(a) of the Internal Revenue Code of 1954 must, under discernible congressional purpose and under the precedents, yield to the bankruptcy priorities.

To urge, as the Government does, that the withheld taxes are not an asset of the bankrupt estate but, notwithstanding, its trust should be impressed on all the other funds that are assets of the estate is hardly equitable, one would think, to those creditors and court officers whose goods and services created these assets and, particularly, where the withheld taxes were never possessed, in any form, by the trustee in bankruptcy and the estate would thereby be denuded (A 47-48).

ARGUMENT

I. WHILE WITHHELD TAXES ARE SUBJECT TO A TRUST IN FAVOR OF THE UNITED STATES CREATED BY SECTION 7501(a), THAT TRUST SHARES THE SAME LIMITATIONS IN BANKRUPTCY AS THE TAXES FROM WHICH IT AROSE

The position of the Government that the provisions of Section 7501(a) of the Internal Revenue Code of 1954 create a tax trust fund that is no part of a bankrupt's estate, but should, even so, enjoy a super-priority as to its unrelated assets, irrespective of the circumstances, appears to be supported by the courts of appeal in the Second, Sixth and Ninth circuits: *City of New York* v. *Rassner*, 127 F.2d 703 (C.A.2); *In re Airline-Arista Printing Corp.*, 267 F.2d 333 (C.A.2); *Hercules Service Parts Corp.* v. *United States*, 202 F.2d 938 (C.A.6); *United States* v. *Sampsell*, 193 F.2d 154 (C.A.9).

On the other hand, the court below (A. 53) and the Third Circuit Court, *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, together with the District Court of Colorado, *In re Green*, 264 F. Supp. 849, hold to the view that taxes held under the provisions of Section 7501(a) are subject to the priorities of Section 64a of the Bankruptcy Act when circumstances require the construction of both.

This would seem to be the state of the cases in the circuits that have dealt with the issue and no ready resolution is presently available except to the extent that this Court spoke to the point in *Nicholas* v. *United States*, 384 U.S. 678, 687-691, where it was stated that "taxes incurred during the arrangement period are expenses of

the Chapter XI proceedings and are therefore technically a part of the first priority under Section 64a(1)".

The Court then noted, at the same place, that these expenses were further subordinated to the expenses of the superseding bankruptcy proceedings by the Congress.

While this opinion was considering income taxes and social security taxes withheld during an arrangement, as in the present case, the issue before the Court was expressly limited to interest thereon accruing after bankruptcy.

Nevertheless, and to that extent, it flatly held that Section 7501(a) by its own language was limited by the bankruptcy precedents and that no trust fund existed as to that interest, reserving the question as to the effect of Section 7501(a) with respect to the principal of the taxes against which the Government sought no trust.

That question now presents itself.

The respondent urges upon the Court the view that a harmonizing construction of the two statutes involved, *Rosenberg* v. *United States*, 346 U.S. 273, 294, would recognize the existence of the Section 7501(a) trust all the way to the door of the bankruptcy court but not inside.

In this manner, the Government has the advantage of strong, administrative measures to protect withheld tax funds from being used by solvent or insolvent employers, and the like, as their own "float" prior to due date which appears to have been the intention of this action of Congress. The *Conference Report, H. Conf. Rep.* No. 1385, 73rd Cong., 2d Sess., P. 32; *The Senate Committee Report, S. Rep.* No. 558, 73rd Cong., 2d Sess., P. 53.

On the other hand, where one liable under Section 7501(a) is not subjected to those strong measures before entering the bankruptcy court, either on his own petition or involuntarily, the trust fund theory ought to dissipate in the face of the limiting language of Section 64a of the Bankruptcy Act and the bankruptcy precedents, assigning the Government then to that precise position in the order of priority established by Congress in an effort to deal evenhandedly with all having claims against the bankrupt, including the Government.

Should, however, these statutes be found not reconcilable, then the precedents of this Court, holding that general non-bankruptcy enactments seeking to create preferences contrary to the bankruptcy priorities cannot prevail, ought to settle the matter. *Guarantee Title & Trust Co.* v. *Title Guarantee & Surety Co.*, 224 U.S. 152; *Davis* v. *Pringle*, 268 U.S. 315; *Missouri* v. *Ross*, 299 U.S. 72; *United States* v. *Key*, 407 F.2d 635 (C.A.7); *United States* v. *Kalishman*, 346 F.2d 514 (C.A.8).

Downgrading of tax claims, moreover, would seem to have been the continuing purpose of Congress since 1926, as noted in the opinion below, *United States* v. *Randall*, 419 F.2d 1068, 1073-1075, when, after more than a century of preference, it withdrew from the Government first priority status, above all else, for tax claims. *3A Collier On Bankruptcy*, 2046-48 and 2155-56; when it placed these claims in sixth priority which positioning was retained in the *Chandler Act* of 1938, Act of June 22, 1938, 52 Stat. 883; when it, also, in the same act held tax claimants to ordinary filing period limits; and when, in the Act of July 5, 1966, 80 Stat. 271, it made dischargeable all taxes due and owing more than three years prior to bankruptcy, except those withheld or collected from others but not paid over.

This persistent policy of Congress is forcefully contrasted in the opinion below, at the same place, with a corresponding upgrading of the priority of administrative expenses. The opinion below, again at the same place, cites *Sen. Rep.* No. 1395 S. 2234, 82d Congress, 2d Sess., P.4, among the other illustrative sources, thusly:

> "Unless provision is made for payment of the costs and expenses necessary to liquidate, administer and close the estate in the ensuing bankruptcy proceedings, ahead of all prior incurred and unpaid expenses, there is always a danger of a breakdown of administration. There should be assurance to the trustee in the ensuing proceedings that the costs and expenses incurred by him, such as bond premiums, insurance premiums, costs of conducting a public sale and compensation for his services and for the services of his attorney, will be paid out of the assets liquidated and administered by him ahead of the prior unpaid costs and expenses."

Should the Government's theory be sustained in this case, the "breakdown of administration" sought to be avoided by the Congress would result. (A. 55).

However persistently and imaginatively the Government argues here that it does not seek to enforce its claim out the bankrupt's estate but, instead, to the proceeds of a statutory fund, the plain fact is that there is no statutory fund.

There is no statutory fund because the trustee in bankruptcy never had tax withholdings delivered to him in any form. The only assets available for satisfaction of the claims of the Government, therefore, or for any other purposes, are the proceeds from the sale of the bankrupt's physical assets which hardly exceed the Government's demand. (A. 47-48).

II. WHILE THE FAILURE OF THE DEBTOR IN POSSESSION TO SEGREGATE THE WITHHELD TAXES MAY NOT HAVE DEFEATED THE TRUST CREATED BY SECTION 7501(a) A RIGHT WAS NOT ALSO CREATED THEREBY TO A SUBSTITUTE RES FROM THE UNRELATED ASSETS OF THE BANKRUPT TO THE HARM OF OTHER CREDITORS

The Government protests under this point that the Court below did not treat with the argument that the failure of the debtor in possession to segregate the withheld funds does not defeat the trust even though the Government cannot trace the funds.

Impliedly, and at times expressly, this tracing failure argument by the Government suggests that the funds in this case are so commingled among the bankrupt's other assets that identification is the problem.

This, as has been stated before, is not the fact. (A. 47-48).

The Government cites a number of authorities on general equity propositions to support its position that the *res* of a constructive trust need not be traced in cases such as this because tracing is only required when necessary to protect others from unfair harm and that these creditors cannot be harmed by not receiving payment from funds which were never properly an asset of the estate.

However, the argument here is not, as the Government urges, but instead, is whether a substitute *res* should be provided when to permit this event would be to indeed harm other creditors and, later, court administrators by depriving them of access to apparent assets which led

them initially to reasonably and substantially change their positions in reliance thereon.

It seems unlikely that the Congress had such an unfair purpose in mind when it provided for the withholding trust.

It seems likely, if not inarguable, on the other hand, that to avoid just such interpretation of the first sentence of Section 7501(a) it limited the effect of the trust in the second sentence.

CONCLUSION

An orderly administration of matters in bankruptcy requires that the question presented be settled by this Court's affirming the Court below.

Respectfully submitted,

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